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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY,
Petitioner,

v.

HARRIS TRUST AND SAVINGS BANK,
as Trustee of the Sperry Master Retirement Trust
No. 2,
Respondent.

On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Second Circuit

BRIEF OF *AMICUS CURIAE* AMERICAN COUNCIL OF LIFE INSURANCE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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INTEREST OF *AMICUS CURIAE*[1]

The American Council of Life Insurance (the "Council") is a national trade association representing 611 life insurance companies which, in the aggregate, have approximately 92% of the assets of all United States life insurance companies and 98% of the insured pension business. By virtue of their sales of pension and annuity contracts to employee benefit plans, these companies play a major role in the nation's retirement system. The Council estimates that, by year-end 1991, retirement benefits covering over 59.3 million participants and beneficiaries under private pension plans in the United States were funded through contracts issued by life insurance companies. *See* American Council of Life Insurance, *1992 Life Insurance Fact Book* 54-60 (1992).

Of a total $746 billion of reserves held by life insurance companies under contracts with retirement plans as of year-end 1991, about $565 billion were held under "General Account contracts." *Id.* at 58. Money paid to an insurance company under such a contract becomes part of the insurer's general corporate assets (usually referred to as the insurer's "General Account assets"), which are derived from all of its different classes of business and which, accordingly, are managed for the collective benefit of all policyholders.[2] In this case, the Second Circuit ruled that

[1] Petitioner and Respondent have consented to the filing of this brief. The parties' consent letters have been filed with the Clerk.

[2] Assets in an insurer's General Account include its buildings, equipment and other operating assets as well as its stocks, bonds, real estate and other investment assets. From its General Account, the insurer pays all of its operating expenses (*e.g.*, salaries, rent, taxes, etc.), all of its obligations to general creditors, and all of its obligations to its life, health, annuity and other policyholders (other than policyholders participating in separate accounts). In most cases, the greatest number of policyholders are individuals and entities other than employee benefit plans. An insurer also pays dividends from this account to policyholders, and, in the case of stock companies, to shareholders. General Account assets are not segregated for the benefit of particular contracts, contractholders or lines of business; all assets are available to satisfy each

the general fiduciary responsibility provisions of the Employee Retirement Income Security Act ("ERISA") were applicable to assets in an insurer's General Account. That ruling directly conflicts with a recent holding of the Third Circuit. It also directly conflicts with nearly two decades of Department of Labor ("DOL") pronouncements that the management of General Account assets is not subject to ERISA's fiduciary rules.

The Council has a vital interest in this case. The ruling of the Second Circuit subjects insurers to rules which would literally require them to manage General Account assets solely in the interests of and for the exclusive purpose of providing benefits to participants and beneficiaries of its ERISA retirement plan contractholders. The Third Circuit has recognized that such a result is incompatible with the customary management of General Accounts for the collective benefit of all policyholders. It has further recognized that such a result is incompatible with state insurance laws which were specifically exempted from ERISA's broad preemption provision and which require an insurer to deal fairly and equitably with all policyholders as a group. The decision of the Second Circuit thus leaves the insurance industry exposed to challenges to longstanding business practices that are required in order to comply with state insurance regulatory standards. In addition, the conflict among the Circuits leaves the insurance industry in an untenable state of uncertainty regarding the nature of its obligations with respect to hundreds of billions of dollars of assets held under General Account contracts issued to employee benefit plans and non-ERISA covered policyholders.

INTRODUCTION AND SUMMARY OF THE ARGUMENT

Nothing could have a more detrimental effect on the operation of this country's insurance industry than uncer-

of the insurer's obligations. *See generally Mack Boring & Parts v. Meeker Sharkey Moffitt*, 930 F.2d 267, 268 (3d Cir. 1991); D. McGill & D. Grubbs, Fundamentals of Private Pensions 492-97 (6th ed. 1989).

tainty concerning the fundamental rules which are to govern the management of its general corporate assets. The federal courts are now divided on precisely this issue. The holding of the Second Circuit in this case seriously undermines the fundamental premises on which the industry has sold billions of dollars of insurance contracts to retirement plans for decades and the system of state insurance laws which have traditionally regulated its business practices. The Third Circuit, on the other hand, has correctly concluded that Congress did not intend ERISA to alter the regulation of this business or to impede the sale of traditional General Account insurance contracts to retirement plans. This Court's review of the Second Circuit's holding is urgently required to resolve the conflict which currently exists among the Circuits and which makes it impossible for insurance companies to conduct their businesses with any reasonable guidance as to their statutory and regulatory duties or reasonable predictability as to the legal consequences of their actions.

1. Unlike Traditional Trust Arrangements, General Account Contracts Do Not Give Rise to Fiduciary Relationships

Trust arrangements and General Account insurance contracts traditionally have constituted the two primary vehicles through which retirement plans have accumulated funds to pay benefits to their participants and beneficiaries.[3] Because those two vehicles are very different, they historically have been governed by fundamentally different schemes of regulation.

A plan placing funds in a trust account of a bank or other financial institution receives no undertakings or guarantees from the trustee as to the investment performance of the trust's assets or their sufficiency to satisfy the plan's obligations to pay benefits. Rather, the trustee simply obligates itself to invest the trust assets in a man-

[3] *See generally, 1992 Life Insurance Fact Book, supra* p. 1, at 54; D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 487-92, 565-70.

ner consistent with the plan's objectives and to return to the plan the trust assets as increased or diminished by investment results. The plan thus retains all of the essential attributes of ownership of the trust's assets. Accordingly, under both the common law of trusts and ERISA, the relationship between a plan and trustee (or investment manager or adviser retained by the plan or trustee to manage the trust assets) has been characterized as a fiduciary relationship. This relationship requires the trustee to segregate the trust's assets from its own assets and to manage them for the exclusive benefit of the plan. *See* ERISA §§ 403(a) & 404(a)(1), 29 U.S.C. §§ 1103(a) & 1104(a)(1).

An insurance company General Account contract is a very different vehicle. Such contracts provide various guarantees through which the insurer agrees to assume risks related to the funding and distribution of plan benefits.[4] Plans that choose to purchase these contracts do so with the understanding that their payments to the insurer will become part of its general corporate assets and will not be managed solely in their interest or applied exclusively for their benefit.[5] Indeed, they generally draw comfort from the fact that the contractual rights which they have

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[4] As to the types of risks assumed by insurers, see K. Black & H. Skipper, *Life Insurance* 494 (11th ed. 1987).

[5] In the early 1960's, many states amended their insurance laws to permit the establishment of separate accounts. Through the separate account, the insurer could offer vehicles that competed with bank trust funds. The single-customer and pooled separate accounts that insurers may establish are analogous to the single-customer or pooled trust accounts established by banks. Assets held in separate accounts back contractual obligations to the specific separate account contractholder or class of contractholders. Unlike the General Account, from which only fixed benefits are paid, the separate account may back fixed or variable benefits (benefits that vary in amount with the investment results of the account). Separate account assets are generally subject to ERISA's fiduciary responsibility provisions. DOL, Definition of "plan assets"—plan investment, 29 C.F.R. § 2510.3-101(h)(1)(iii). For a description of separate accounts, see generally D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 494-97.

acquired in exchange for such consideration will be supported on an unsegregated basis by a large pool of assets derived from various classes of business.

Recognizing the fundamental differences between the placement of funds in trust and the purchase of an insurance contract, the common law has historically characterized the relationship between an insurer and a General Account contractholder as a contractual rather than a fiduciary relationship.[6] Accordingly, prior to ERISA's enactment, insurers were not constrained by trust law requirements from issuing contracts whose obligations were supported by commingled assets, the management of which could not be undertaken on behalf of any particular contractholder or class of contractholders with the undivided loyalty expected of a fiduciary. Instead, the interests of employee benefit plans and other General Account contractholders have been protected by state insurance laws. These laws are designed to assure that an insurer is able to satisfy its contractual obligations to all contractholders, and that all contractholders are treated equitably and on a non-discriminatory basis.[7] Employee benefit plan con-

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[6] *Equitable Life Assur. Soc'y v. Brown*, 213 U.S. 25, 46 (1909); *Ohio State Life Ins. Co. v. Clark*, 274 F.2d 771, 778 (6th Cir.), *cert. denied*, 363 U.S. 828 (1960); *Andrews v. Equitable Life Assur. Soc'y*, 124 F.2d 788, 789 (7th Cir. 1941), *cert. denied*, 316 U.S. 682 (1942); *Rochester Radiology Assoc. v. Aetna Life Ins. Co.*, 616 F. Supp. 985, 988 (W.D.N.Y. 1985).

[7] *See* N.Y. Ins. Law § 4239 (authorizing the superintendent of insurance to issue regulations providing for "the equitable allocation of income and expenses among lines of business and as between investment expenses and insurance expenses"); N.Y. Comp. Codes R. & Regs. tit. 11, § 91.1(a) (allocation of income and expenses of a life insurer must, among other things, "comply with Insurance Law requirements that holders of insurance policies and annuity contracts be treated equitably"); *id.* § 91.4(a).

State laws do not subject an insurance company's General Account investments to the "exclusive benefit" standard prescribed by ERISA. Rather, state insurance laws customarily specify the types of assets in which insurance companies may invest for their General Account—and impose a general requirement of prudence. *See, e.g.*, N.Y. Ins. Law

tractholders and their participants and beneficiaries are protected, as well, by the fiduciary requirements placed on a plan trustee, administrator, or other plan representative in connection with having responsibility for the purchase, monitoring and disposition of these contracts.[8]

2. ERISA Was Not Intended to Alter the Traditional Regulation of General Account Contracts

In enacting ERISA, Congress did not manifest any intention to depart from the traditional characterization of General Account insurance arrangements or to impose upon them a scheme of regulation that was incompatible with their customary operation and regulation under state insurance laws. To the contrary, ERISA includes a specific provision that excludes from the statute's fiduciary responsibility provisions the management of funds received by an insurer under "guaranteed benefit policies."[9] This

§ 1405(c). State law provides a variety of other forms of protection for purchasers of General Account contracts—including laws requiring filing and approval of the contracts themselves, state guaranty funds, and laws prescribing equitable distribution of assets in the event of insolvency.

[8] *Harris Trust & Savings Bank v. John Hancock Mut. Life Ins. Co.*, 970 F.2d 1138, 1145 (2d Cir. 1992) (stating that "the holder of the contract is the entity subject to fiduciary responsibility"); *see* DOL, Letter on Fiduciary Responsibility and Plan Terminations (Mar, 13, 1986), *published in* 13 Pens. Rep. (BNA) 472 (Mar. 17, 1986), *available in* WESTLAW, 13 BPR 472, BNA-PEN database.

[9] Under ERISA, a party becomes a fiduciary to an employee benefit plan to the extent that it exercises discretionary authority or control over "the management or disposition of [plan] assets." ERISA § 3(21)(A)(i), 29 U.S.C. § 1002(21)(A)(i). ERISA § 401(b)(2) provides that plan assets do not include the assets of an insurer that has issued a "guaranteed benefit policy":

> (2) In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of such insurer. For purposes of this paragraph:
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> * * * *
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> (B) The term "guaranteed benefit policy" means an insurance policy or contract to the extent that such policy or contact provides for benefits the amount of which is guaranteed by the insurer. Such term includes any surplus in a separate account, but excludes any other portion of a separate account.

29 U.S.C. § 1101(b)(2).

exception is consistent with ERISA's "savings clause"—which excepts any state law which regulates the business of insurance from the application of ERISA's broad preemption provision.[10]

Shortly after ERISA's enactment, the DOL, the agency charged with that statute's enforcement, confirmed that the management of General Account assets is excluded from ERISA's fiduciary responsibility provisions. An interpretive bulletin issued by the DOL states that the consideration placed by an insurer in its General Account under a contract or policy of insurance "shall not be considered to be plan assets."[11] The DOL has reaffirmed this interpretation several times over the past 18 years—most significantly, in its 1986 final regulation relating to the definition of plan assets. 51 Fed. Reg. 41,262, 41,275 & 41,278 (Nov. 13, 1986). Since ERISA became law, the DOL has never asserted in any enforcement action or otherwise that an insurer was acting as a fiduciary in connection with the management of General Account assets or by virtue of the issuance of any form of General Account contract to an employee benefit plan.

[10] ERISA § 514(b)(2), 29 U.S.C. § 1144(b)(2) (stating that ERISA provision preempting state law shall not be construed to "exempt or relieve any person from any law of any State which regulates insurance, banking, or securities").

[11] DOL Interpretive Bulletin 75-2, 29 C.F.R. § 2509.75-2, states in pertinent part:

> If an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in its general asset account, the assets in such account shall not be considered to be plan assets.

29 C.F.R. § 2509.75-2(b).

3. The Second Circuit Has Radically Altered the Accepted Understanding That the Management of General Account Assets Is Subject to State Insurance Regulation, Not ERISA's Fiduciary Standards

In this case, the Second Circuit has held that ERISA's general fiduciary responsibility provisions apply to an insurer's management of General Account assets by virtue of its issuance of a form of group annuity contract which was in common use at the time of ERISA's enactment and which continues in common use today. In reaching that result, the Second Circuit ignored the substantial differences between General Account contracts and those types of arrangements which traditionally have been subject to fiduciary standards of conduct. Furthermore, it misinterpreted the meaning, scope and intent of the relevant statutory provisions and administrative interpretations. The Second Circuit's position is in direct conflict with a recent decision of the Third Circuit, *Mack Boring & Parts v. Meeker Sharkey Moffitt*, 930 F.2d 267 (3d Cir. 1991). In *Mack Boring*, the Third Circuit analyzed the same statutory text, legislative history, and administrative pronouncements as the Second Circuit. The Third Circuit determined, however, that ERISA's fiduciary responsibility provisions were incompatible with the normal operations of a General Account. The court then concluded that there was nothing in ERISA's statutory language or legislative history to evidence that Congress intended to create "so severe a disruption of insurance practices" as would ensue from the application of ERISA's fiduciary responsibility provisions to the management of General Account assets and from the creation of "dual loyalties" for insurance companies. *Id.* at 275 n.17.

Absent review by this Court, the insurance industry faces uncertainty as to the extent to which General Account assets can continue to be commingled and applied on an unsegregated basis to support ERISA related and non-ERISA related obligations to policyholders. The extent to which decisions concerning these assets can take into account the interests of non-ERISA policyholders also is unclear. While leaving the insurance industry in a significant dilemma as to how to conduct its future operations, the Second Circuit's decision invites challenges under ERISA to the myriad business and investment decisions that have been made in the past by insurers with a reasonable understanding, supported by nearly two decades of consistent DOL pronouncements, that ERISA's fiduciary responsibility provisions are inapplicable to the management of their General Accounts.

ARGUMENT

I. THE DECISION BELOW SHOULD BE REVIEWED IN ORDER TO RESOLVE A CLEAR CONFLICT AMONG CIRCUITS ON AN ISSUE OF VITAL SIGNIFICANCE TO THE INSURANCE INDUSTRY AND ITS POLICYHOLDERS

This case presents the question of whether ERISA's general fiduciary responsibility provisions are applicable to an insurance company's management of General Account assets by virtue of its issuance of General Account contracts to retirement plans. The interests of insurance company policyholders whose contract rights are secured by General Account assets traditionally have been protected under state insurance laws, a scheme of regulation which is fundamentally incompatible with ERISA's fiduciary standards. This issue, which has spawned a clear conflict among the Circuits, is one of great significance to the insurance industry, to retirement plan participants whose benefits are funded and distributed through General Account contracts, and to all other insurance company policyholders whose rights are secured by insurance company General Accounts. The holdings of the Second and Third Circuits concern a broad category of contracts which have been sold to an enormous number of retirement plans. The differences between the Circuits cannot be reconciled on the basis of differences between the particular contracts which were reviewed in those cases.

Both this case and *Mack Boring* address contracts which are commonly referred to as "unallocated General Account contracts." Both before and after ERISA's enactment, unallocated contracts have been the most popular form of insurance company contract sold to retirement plans.[12] The Council estimates that insurance companies hold over $315 billion of funds in their General Accounts under unallocated contracts.[13]

Amounts contributed pursuant to an unallocated contract are not necessarily applied immediately to the purchase of guaranteed benefits for participants.[14] Rather, amounts contributed by the contractholder are credited to a bookkeeping account which is charged with the cost of providing guaranteed benefits to plan participants as they become eligible to receive them. The insurer typically provides guarantees with respect to the preservation of the principal balance of the bookkeeping account as well as the rates at which the funds in such bookkeeping account can be applied to the purchase of guaranteed benefits for participants. Most of these contracts, including those at issue in this case and in *Mack Boring*, provide that the interest to be credited to these accounts will be based in whole or in part on the insurer's investment results.[15]

As John Hancock Mutual Life Insurance Company ("Hancock") demonstrates in its Petition, and as the Second Circuit acknowledged, the Second and Third Circuits have adopted irreconcilable standards for determining whether and to what extent the consideration received by

[12] D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 551. For a recent description of unallocated contracts, see generally *id.* at 550-64.

[13] *1992 Life Insurance Fact Book*, *supra* p. 1, at 58.

[14] D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 552. In contrast, amounts contributed pursuant to "allocated" General Account contracts are applied immediately to the purchase of guaranteed benefits for participants, even though benefits are not yet payable under the plan. *See id.* at 526.

[15] *Mack Boring*, 930 F.2d at 268-69; *see* D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 552.

insurers under unallocated contracts and placed in their commingled General Accounts are "plan assets" whose management becomes subject to ERISA's general fiduciary responsibility provisions. Hancock's Petition for a Writ of Certiorari 12-13; *Harris Trust & Savings Bank v. John Hancock Mutual Life Insurance Co.*, 970 F.2d 1138, 1144 (2d Cir. 1992). The Third Circuit concluded that funds held under an unallocated General Account contract are excluded from the reach of ERISA so long as such funds may be applied immediately or in the future to the payment of guaranteed benefits to plan participants and beneficiaries, a condition which is invariably satisfied as to the entirety of unallocated General Account contract funds. *Mack Boring*, 930 F.2d at 273-75. The Second Circuit rejected such holding and ascribed "plan asset" status to a portion of these same type of unallocated funds. *Harris Trust*, 970 F.2d at 1143-44. The resultant conflict calls into question the status under ERISA of hundreds of billions of dollars of unallocated General Account contract funds, leaving the insurance industry in an untenable position in determining what rules are to apply to the management and administration of its General Account assets.[16]

[16] The fact that the Second Circuit's decision is ostensibly limited to certain funds (referred to in the decision as "free funds") under the Hancock contract does not diminish the significance of this conflict. A large portion of the funds held by insurers under unallocated contracts would be regarded as "free funds" under the Second Circuit's reasoning. More significantly, the term "free funds" does not refer to separately managed and identifiable General Account assets. Such "funds" exist only as bookkeeping entries which can change as frequently as every day. Inasmuch as all of an insurer's General Account assets secure all General Account obligations on an unsegregated basis, the Second Circuit's holding may affect all such assets and all insurance company practices concerning the management and administration of such assets.

II. BY CREATING SUBSTANTIAL UNCERTAINTY OVER THE SCHEME OF REGULATION TO BE APPLIED TO INSURANCE COMPANY GENERAL ACCOUNTS, THE SECOND CIRCUIT'S DECISION AND RESULTANT CONFLICT AMONG THE CIRCUITS WILL HAVE A SUBSTANTIAL ADVERSE IMPACT ON THE EFFECTIVE OPERATION OF INSURANCE BUSINESSES AND MARKETS

The decision of the Second Circuit in this case and the resultant conflict among Circuits presents insurance companies with three serious and unresolvable dilemmas, each of which materially affects their ability to conduct their business in a fashion which is consistent with their customary and necessary practices, the state laws which govern such practices, and the expectations of their policyholders and other constituents. As a result, there is a compelling need for this Court to grant Hancock's Petition and resolve the conflict among the Circuits.

First, the Second Circuit's ruling subjects insurers to a scheme of regulation which the Third Circuit found to be incompatible with the nature of an insurer's state law obligations to General Account contractholders and with the regulation of General Accounts under state insurance laws. *Mack Boring*, 930 F.2d at 275 n.17; *see also Harris Trust & Savings Bank v. John Hancock Mutual Life Insurance Co.*, 722 F. Supp. 998, 1020 (S.D.N.Y. 1989), *rev'd in part and aff'd in part*, 970 F.2d 1138 (2d Cir. 1992). ERISA requires that a fiduciary manage plan assets "solely in the interest of" plan participants and beneficiaries and "for the exclusive purpose of" paying benefits to them. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1). An insurance company General Account, however, whose assets support all general business and policyholder obligations on a commingled and unsegregated basis, cannot be managed single-mindedly in the interests of any particular policyholder or class of policyholders. To so act would violate state insurance law which requires an insurer to deal fairly and equitably with all policyholders as a group.

The Second Circuit does not acknowledge this fundamental conflict, let alone offer any guidance as to how to resolve it.[17] As a result, no prudent insurer can avoid considering whether it can continue to offer products which historically have funded a large percentage of this nation's private pensions. Even more significantly, with respect to the hundreds of billions of dollars which already are held in insurance company General Accounts under contracts of the type addressed by this case, insurers are now left to consider how to manage these accounts in conformity with conflicting federal fiduciary and state insurance regulatory standards and objectives. In this regard, the segregation of assets held in the General Account to support business which might be subject to ERISA's fiduciary standards, if it were attempted, is neither a solution which would resolve this problem, nor one which would be compatible with the expectations or interests of an insurer's ERISA covered or non-ERISA covered contractholders.[18]

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[17] Ironically, in failing to acknowledge this conflict with state law duties, the Second Circuit ignored its prior holding in *Levy v. Lewis*, 635 F.2d 960 (2d Cir. 1980). There, the court found it inappropriate to impose fiduciary status on the New York Superintendent of Insurance in its capacity as rehabilitator of a financially troubled insurer. The court concluded that:

> Lewis is not the type of official whom Congress had in mind as an ERISA fiduciary. . . . Lewis's statutory obligation is to consider fairly the claims of all creditors of the bankrupt company; as a fiduciary, he could not help being put in a position of divided loyalty from the outset.

635 F.2d at 968.

[18] Any attempt by an insurer to set aside a portion of its General Account assets for the exclusive benefit of particular policyholders and to manage such assets solely in their interests is both infeasible and contrary to the expectations of General Account contractholders for several reasons. First, state insurance laws require that all General Account assets be available to support all General Account liabilities. Therefore, it would be legally impossible to manage any assets for the exclusive benefit of only some of the policyholders whose contractual rights are supported by such assets. Second, even if such a segregation of assets were legally possible, the very process of dividing up such

Second, the Second Circuit's decision leaves insurance companies with large exposure to litigation for the manner in which they have conducted their business in the past. Such exposure is both unexpected and unwarranted. The relationship between insurers and their General Account policyholders and the management of insurance company General Accounts have traditionally been subject to state insurance regulation. Nothing in the text or legislative history of ERISA evidences a congressional intent to disrupt that scheme through the application of ERISA's fiduciary standards. *Mack Boring*, 930 F.2d at 275 n.17 (finding no evidence that "Congress had intended so severe a disruption of insurance practices, practices that had been in existence for almost three decades before the enactment of ERISA"). As preeminent pension scholars have stated, the rationale for the exemption of General Account assets from ERISA's fiduciary responsibility provisions, "apart from its inherent logic, is that the general account operation, including its investment activities, are adequately supervised by state regulatory authorities." D. McGill & D. Grubbs (6th ed.), *supra* note 2, at 439. The DOL has consistently and unambiguously stated that General Account assets are not plan assets subject to regulation under ERISA.[19] As a consequence, insurers reasonably have not considered themselves to be fiduciaries in managing their General Account assets.[20] Indeed, to have acted otherwise

assets would be subject to conflicting ERISA and state regulatory standards. Finally, such a segregation of assets would deprive General Account policyholders of all of the benefits of having their assets supported by a large pool of assets derived from diversified risks, a result contrary to their expectations in purchasing their contracts and to the terms of their contracts.

[19] *See infra* pp. 19-20 & note 24.

[20] In *Peoria Union Stock Yards Co. Retirement Plan v. Penn Mut. Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983), the Seventh Circuit, on appeal by the plaintiff from dismissal of the complaint, reached the same result as the Second Circuit in this case. However, the industry did not rely on *Peoria Union* (or its progeny) because of its weak precedential value. In *Peoria Union*, after the defendant insurance company moved for rehearing, the Council submitted an *amicus curiae*

would have been contrary to the reasonable expectations of their contractholders and their obligations under state insurance laws. The Second Circuit's holding, however, would permit dissatisfied customers to seek damages or reformation of their contracts on the grounds that insurers failed to manage General Account assets exclusively for their benefit or solely in their interests. Moreover, such litigation would be judged pursuant to fiduciary rules, under which the insurer's conduct would be assessed only in terms of the interests of the plaintiff contractholder without regard for the interests of all other insurance company contractholders and constituents whose interests may be vitally affected by such conduct.

Finally, one of ERISA's fundamental purposes is to assure that the administration and funding of employee ben-

brief that set forth—for the very first time in that case—ERISA's legislative history, DOL interpretation, and the policy implications of applying ERISA to General Account assets. In denying the petition for rehearing, the Seventh Circuit expressly acknowledged that it had not considered these matters and noted that:

> In view of the fact that the panel decision merely reverses the dismissal of the complaint under Fed. R. Civ. P. 12(6)(b) [sic], the case is at an early stage and the appellee will have ample opportunity to present its arguments to the district court consistently with the flexible contours of the doctrine of law of the case.

Peoria Union, 698 F.2d at 328. For this reason, the soundness and precedential value of the holding in *Peoria Union* have been questioned by many courts, including the trial court in the present case, a recent decision in the Seventh Circuit, and the Third Circuit. *See Harris Trust & Savings Bank v. John Hancock Mut. Life Ins. Co.*, 722 F. Supp. 998, 1015-16 n.25 (S.D.N.Y. 1989), *aff'd in part and rev'd in part*, 970 F.2d 1138 (2d Cir. 1992); *Associates in Adolescent Psychiatry v. Home Life Ins. Co.*, 729 F. Supp. 1162, 1189 (N.D. Ill. 1989) (noting that *Peoria Union* was decided before the DOL "had fully developed the views that were eventually crystallized" in the plan asset regulations), *aff'd*, 941 F.2d 561 (7th Cir. 1991); *Mack Boring*, 930 F.2d at 271 n.11 ("Because the *Peoria Union* court did not give full consideration to those authorities and contentions not drawn to its attention until the petition for rehearing, its decision cannot be read as a rejection of those authorities and contentions. Indeed, had such arguments been made before the court of appeals prior to its decision on the merits, the result it reached might well have been different.").

efit plans would be subject to uniform national standards. *See Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 56 (1987); *Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208, 1215 (8th Cir.), *cert. denied*, 454 U.S. 1084 (1981); *see also Menhorn v. Firestone Tire & Rubber Co.*, 738 F.2d 1496, 1498 (9th Cir. 1984). Such a purpose is broadly and materially undermined to the extent that the basic scheme of regulation to be applied to the relation between insurance companies and employee benefit plans who purchase General Account contracts from such companies remains a matter of substantial conflict among the federal courts. The importance of this issue from the perspective of both the industry and of employee benefit plans and other policyholders dictates that its outcome should not be determined on the basis of forum shopping or the happenstance of the particular jurisdictions in which a defendant is amenable to suit.

III. THE SECOND CIRCUIT MISCONSTRUED THE STATUTE AND THE DEPARTMENT OF LABOR'S POSITION

Immediately following ERISA's effective date in 1975, the DOL clarified for the pension industry that the "guaranteed benefit policy" safe harbor of section 401(b)(2), 29 U.S.C. § 1101(b)(2), evidenced congressional intent that General Account assets are not to be treated as "plan assets" for purposes of ERISA's fiduciary responsibility rules. In *Mack Boring*, the Third Circuit considered the "guaranteed benefit policy" provision in its historical context and came to the same conclusion. That interpretation is entirely consistent with the statute's language and legislative history.

Section 401(b) provides two safe harbors from the application of plan asset status. Subsection (b)(1) provides that, when a plan purchases the securities of an investment company (mutual fund), the underlying assets of the investment company are *not* plan assets. Similarly, subsection (b)(2) provides that, when a plan invests in a "guaranteed benefit policy," the underlying assets of the insurance company are *not* plan assets. More specifically,

section 401(b)(2) defines "guaranteed benefit policy" as an insurance policy or contract: 1) "to the extent," 2) it "provides for" 3) "benefits," 4) "the amount of which is guaranteed," 5) including "surplus in a separate account," 6) but excluding "any other portion of a separate account."

The Second Circuit ignored or misconstrued several of these phrases. It concluded that if any portion of the funds held under a General Account contract are not immediately necessary to support the costs of paying guaranteed benefits to participants and no guarantees of investment returns on such funds are furnished to the contractholder, then "to [that] extent" the contract is not a guaranteed benefit policy and, consequently, such funds are plan assets. Such a reading of the guaranteed benefit policy exception ignores the phrase "provide for" and mistakenly assumes that the term "benefits" refers to any type of *payment* under the contract, including the crediting of interest to the employer or other plan sponsor. *Harris Trust*, 970 F.2d at 1143.[21]

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[21] Another ground for questioning the Second Circuit's decision is that it apparently concluded that the "guaranteed benefit policy" provision was an "exclusive" safe harbor, so that any insurance company assets not falling within the definition constitute plan assets. By its express terms, however, § 401(b) defines only two limited circumstances in which assets are *not* plan assets. In no way does it purport to impose plan asset status in all other circumstances. The non-exclusivity of § 401(b) is evidenced in Congress's unbridled mandate in 1985 for the DOL to define plan assets in a comprehensive regulation. Pub. L. No. 99-272, § 11018(d), 1986 U.S.C.C.A.N. (100 Stat.) 277-80 (directing the DOL to "adopt final regulations defining 'plan assets' by December 31, 1986"). In its 1986 regulation, the DOL concluded that plan asset status would *not* apply to the assets of *any* entity treated as an "operating company." 29 C.F.R. § 2510.3-101(a)(2)(i) (1992). An operating company is defined to include any "entity that is *primarily engaged* . . . in the production or sale of a service other than the investment of capital. *Id.* at § 2510.3-101(c) (emphasis added). A General Account is the operating account of an insurance company, an entity primarily engaged in the business of assuming risks through the sale of insurance products. The Second Circuit, however, failed to consider whether the operation of insurers' General Accounts fell within this regulatory exemption for plan asset status.

The Third Circuit, on the other hand, properly construed and considered *all* key phrases of section 401(b)(2) in concluding that a General Account contract is a "guaranteed benefit policy" in its entirety if all General Account contract funds can be applied immediately or in the future to provide benefits to plan participants which are guaranteed by the insurer. In particular, it recognized that General Account assets "provide for" guaranteed benefits even when such benefits are not immediately payable.[22] It found that ERISA uses the term "benefits" to mean solely payments to participants and beneficiaries, not to the employer or other plan sponsor. 930 F.2d at 273 (footnote omitted).[23] The Third Circuit noted that the purpose of the phrase excluding separate accounts (other than surplus) was to close a "very large loophole" so that the separate

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[22] The Third Circuit in *Mack Boring* recognized that the amount credited to the contract's accumulation account did indeed "provide[] for" guaranteed benefits:

> [The] contract clearly "makes, procures or furnishes for the future use" of the plan participants a fixed amount of benefits. Section 401(b)(2)(B) does not, on its face, require that the benefits contracted for be delivered immediately, and we will not read into the statute such a requirement.

Mack Boring, 930 F.2d at 273. The Second Circuit recognized that the so-called "free funds" held under the contract could be used to provide future guaranteed benefits to participants. Ignoring the "provides for" phrase, however, the Second Circuit found it significant that the contract "does not [provide guarantees] *at all times* with respect to all the benefits derived from the . . . free funds." *Harris Trust*, 970 F.2d at 1143.

[23] The Second Circuit, in contrast, concluded that "benefit" for purposes of § 401(b)(2) encompassed payments and obligations to plan sponsors, in concluding that the so-called "non-guaranteed portion [of the contract] is dependent upon the insurer's investment experience and therefore is variable with respect to the benefits it provides." *Harris Trust*, 970 F.2d at 1143. There is, however, no evidence that Congress intended "benefit" to have one meaning for one provision of ERISA and a different meaning for all others. *See S & M Inv. Co. v. Tahoe Regional Planning Agency*, 911 F.2d 324, 328 (9th Cir. 1990) ("When the same [undefined] word or phrase is used in different parts of a statute, we presume that the word or phrase has the same meaning throughout."), *cert. denied*, 111 S. Ct. 963 (1991).

account assets underlying a fixed-benefit contract would not be excluded from plan asset status. *Mack Boring*, 930 F.2d at 274. In this context, the Third Circuit correctly concluded that the phrase "to the extent" distinguished between the General Account and separate account portions of a single contract. The Second Circuit failed to make any attempt to reconcile these disparate phrases.

Because ERISA lacks a comprehensive definition of plan assets, the pension industry, immediately after the statute's enactment in 1974, expressed its concern about the potential reach of ERISA's fiduciary provisions to its ongoing operations. To allay these concerns, the DOL stepped in and, in February 1975, issued its Interpretive Bulletin 75-2 ("IB 75-2"), a broad pronouncement regarding the types of assets, including General Account assets, that do not constitute plan assets. *See* 40 Fed. Reg. 31,598 (July 28, 1975, issued Feb. 6, 1975) (currently codified at 29 C.F.R. § 2509.75-2). For example, although section 401(b)(1) speaks only of investment company securities, the DOL stated that a plan's investment in the assets of other entities also would not cause the entities' underlying assets to be deemed plan assets. 29 C.F.R. § 2509.75-2(a). And, as to General Account assets, the DOL clearly stated that General Account assets were not to be deemed plan assets. 29 C.F.R. § 2509.75-2(b).

The Second and Third Circuits are in clear conflict as to the intent of IB 75-2. The Second Circuit erroneously concluded that IB 75-2 applies only for purposes of determining the application of the prohibited transaction rules of sections 406 through 408 of ERISA. *Harris Trust*, 970 F.2d at 1145. The Third Circuit, in contrast, found that the DOL intended IB 75-2 to apply for all purposes of ERISA. *Mack Boring*, 930 F.2d at 276. The correctness of the Third Circuit's position is made indisputably clear by the DOL's affirmance of its position on General Account assets in its final regulation relating to the definition of plan assets issued in 1986. 51 Fed. Reg. 41,262, 41,275,

41,278 (Nov. 13, 1986).[24] The Third Circuit recognized that, in "affirm[ing] the viability of IB 75-2(b) in the context of a plan assets regulation, we must assume that the regulation speaks authoritatively with respect to plan asset identification." *Mack Boring,* 930 F.2d at 276. There simply is no language in ERISA to suggest that assets can be "plan assets" for purposes of the general fiduciary responsibility provisions but not for purposes of the prohibited transaction provisions.[25]

In summary, the Second Circuit has relied on a misreading of one phrase ("to the extent that") of the "guaranteed benefit policy" exception and an indefensibly narrow construction of the intended scope of a definitive agency interpretation of ERISA, to radically alter the long-accepted understanding that the management of General Account assets is subject to state regulation, not ERISA's fiduciary standards.

CONCLUSION

The Petition for a Writ of Certiorari should be granted.

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[24] *See also* 44 Fed. Reg. 50,363, 50,364 n.4 (Aug. 28, 1979) (citing IB 75-2, the DOL stated that it "has previously interpreted this provision [section 401(b)(2)] to mean, generally that assets held in an insurer's general account to support benefits under a contract purchased by a plan are not plan assets, but that assets held for the same purpose in the insurer's separate account are plan assets.").

[25] ERISA § 408(a), 29 U.S.C. § 1108(a), contains an administrative procedure for the DOL to grant exemptions from the prohibited transaction provisions. An "interpretive bulletin," however, is not an exemption. Rather, IB 75-2 sets forth the DOL's position that General Account assets are not plan assets.

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APPENDIX

APPENDIX

ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A), provides:

Definitions

For purposes of this subchapter:

* * *

(21)(A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibilities to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 1105(c)(1)(B) of this title.

ERISA §401(b), 29 U.S.C. §1101(b), provides:

Coverage

* * *

(b) For purposes of this part:

(1) In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940 [15 U.S.C.A. § 80a-1 et seq.], the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company.

(2) In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely be reason of the issuance of

such policy, be deemed to include any assets of such insurer. For purposes of this paragraph:

(A) The term "insurer" means an insurance company, insurance service, or insurance organization, qualified to do business in a State.

(B) The term "guaranteed benefit policy" means an insurance policy or contract to the extent that such policy or contract provides for benefits the amount of which is guaranteed by the insurer. Such term includes any surplus in a separate account, but excludes any other portion of a separate account.

ERISA §403, 29 U.S.C. §1103, provides in pertinent part:

Establishment of trust

(a) Benefit plan assets to be held in trust; authority of trustees

Except as provided in subsection (b) of this section, all assets of an employee benefit plan shall be held in trust by one or more trustees. Such trustee or trustees shall be either named in the trust instrument or in the plan instrument described in section 1102(a) of this title or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that—

(1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this chapter, or

(2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 1102(c)(3) of this title.

ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1), provides:

Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

ERISA § 408(a), 29 U.S.C. § 1108(a), provides:

Exemptions from prohibited transactions

(a) Grant of exemptions

The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any fiduciary or transaction, or

class of fiduciaries or transactions, from all or part of the restrictions imposed by sections 1106 and 1107(a) of this title. Action under this subsection may be taken only after consultation and coordination with the Secretary of the Treasury. An exemption granted under this section shall not relieve a fiduciary from any other applicable provision of this chapter. The Secretary may not grant an exemption under this subsection unless he finds that such exemption is—

(1) administratively feasible,

(2) in the interest of the plan and of its participants and beneficiaries, and

(3) protective of the rights of participants and beneficiaries of such plan.

Before granting an exemption under this subsection from section 1106(a) or 1107(a) of this title, the Secretary shall publish notice in the Federal Register of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons opportunity to present views. The Secretary may not grant an exemption under this subsection from section 1106(b) of this title unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2), and (3) of this subsection.

ERISA § 514(b)(2)(A), 29 U.S.C. § 1144(b)(2)(A) provides:

Other laws

* * *

(b) Construction and application

(2)(a) Except as provided in subparagraph (B), nothing in this subchapter shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities.

29 C.F.R. § 2509.75-2(b) provides:

(b) *Contracts or policies of insurance.* If an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in its general asset account, the assets in such account shall not be considered to be plan assets. Therefore, a subsequent transaction involving the general asset account between a party in interest and the insurance company will not, solely because the plan has been issued such a contract or policy of insurance, be a prohibited transaction.

29 C.F.R. § 2510.3-101 provides in pertinent part:

Definition of "plan assets"—plan investments.

(a) In general.

* * *

(2) Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that—

(i) The entity is an operating company,

* * *

(c) Operating company. (1) An "operating company" is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, it the production or sale of a product or service other than the investment of capital. The term "operating company" includes an entity which is not described in the preceding sentence, but which is a "venture capital operating company" described in paragraph (d)

or a "real estate operating company" described in paragraph (e).

* * *

(h) Specific rules relating to plan investments. Notwithstanding any other provision of this section—

(1) Except where the entity is an investment company registered under the Investment Company Act of 1940, when a plan acquires or holds an interest in any of the following entities its assets include its investment and an undivided interest in each of the underlying assets of the entity:

* * *

(iii) A separate account of an insurance company, other than a separate account that is maintained solely in connection with fixed contractual obligations of the insurance company under which the amounts payable, or credited, to the plan and to any participant or beneficiary of the plan (including an annuitant) are not affected in any manner by the investment performance of the separate account.

N.Y. Ins. Law § 1405(c) provides:

Investments

(c) In addition to other requirements of law (statutory or otherwise) that affect the standard of care of directors and officers of corporations, in making investments under this section, directors and officers shall perform their duties in good faith and with that degree of care that an ordinarily prudent individual in a like position would use under similar circumstances. In the case of investments made under paragraphs two and six of subsection (a) of this section and investments that are substantially of the same types as those eligible for investment under such paragraphs, but are made under paragraph seven of such subsection, the institution that determines the eligibility of any such investment shall be a solvent institution whose obligations, if any, are not in default as to principal or interest, unless such investment is necessary to protect an investment theretofore made in the securities of such institution.

N.Y. Ins. Law § 4239 provides:

Allocation and reporting of income and expenses of life insurers

(a) In order to enable the superintendent to determine compliance with this chapter, he may issue reasonable regulations prescribing standards for the equitable allocation of income and expenses as among lines of business and as between investment expenses and insurance expenses. No such regulation or amendment thereto shall be promulgated except upon notice to all insurers affected thereby, and after hearing. Such regulation or amendment shall not preclude the use of other reasonable and equitable standards previously approved by the superintendent. He may also promulgate regulations defining the items of income and expenses to be reported in each line of the annual statement. Any regulation or amendment thereto shall be promulgated at least six months before the beginning of the calendar year in which the same shall take effect.

(b) The restrictions in subsection (a) hereof as to notice, hearing, and effective period shall not apply to such regulations or amendments as may be approved by the superintendent for calendar years as to which similar regulations or amendments have been adopted by the National Association of Insurance Commissioners.

(c) If the superintendent finds, after notice and hearing, that any such insurer has failed to comply with the requirements of this section, he may order such insurer to change its methods of reporting or to modify its basis of allocation so as to produce reasonable and equitable results.

N.Y. Comp. Codes R. & Regs. tit. 11 § 91.1(a) provides:

Purpose

(a) Equitable allocation of income and expenses of a life insurer is the responsibility of its management. Its exercise of such responsibility, while shaped by appropriate consideration of such factors as size, mode of operation and classes of business written by the insurer, must accord with sound accounting practice and comply with Insurance Law requirements that holders of insurance policies and annuity contracts be treated equitably (§§ 204, 209, 216, 221, 223 and 226) and that insurance policies and annuity contracts be self-supporting on reasonable assumptions as to mortality, morbidity, interest and expense (§§ 213 and 221).

N.Y. Comp. Codes R. & Regs. tit. 11 § 91.4(a) provides:

Standards and rules for allocation of income (receipts) and expenses

(a) General instructions. (1) It is the responsibility of each life insurer to use only such methods of allocation as will produce a suitable and equitable distribution of income and expenses by lines of business. Unless impractical or unfeasible, an insurer may use only such methods of allocation in its distribution of income and expenses within annual statement lines of business as are compatible with the methods it uses for distribution between annual statement lines of business.

(2) Each life insurer shall maintain records with sufficient detail to show fully:

(i) the system actually used for allocation of income and expenses;

(ii) the actual bases of allocation;

(iii) the actual monetary distribution of the respective items of income, salaries, wages, expenses, and taxes to:

(a) units of activity or functions, if any distribution is made on such basis,

(b) fund accounts, if any distribution is made on the basis thereof, reflecting separately, for each fund, premiums or considerations, investment income, capital gains and losses, benefit payments, expenses, and provision for reserves,

(c) annual statement lines of business,

(d) companies, and

(e) a recapitulation and reconciliation of items (a), (b), (c) and (d) with the insurer's books of account and annual statement.

(3) Such records shall be classified and indexed in such form as to permit ready identification between the item allocated and the basis upon which it was allocated, and shall be maintained in such a manner as to be readily accessible for examination. These records shall bear a date and shall identify the person responsible for the preparation thereof.

(4) Bases of allocation shall be reviewed periodically to ascertain their suitability for continued use.

(5) Allocations of income and expenses between companies shall be treated in the same manner as if made for major annual statement lines of business.